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SUBJECT: Commerzbank Buys Dresdner, Fuelling Consolidation Debate

¶1. Summary: Commerzbank's acquisition of Dresdner Bank this week is the third and largest bank takeover in Germany this year, as global financial turmoil brings long-awaited consolidation to Germany's notoriously over-banked financial sector. With the deal, Commerzbank picks up a bank which has suffered greatly in the recent downturn, but creates an entity large enough to rival Germany's biggest bank, Deutsche Bank, in many spheres. The deal may spur further consolidation among private banks, but does not represent a significant change to Germany's three-pillar bank system. End Summary.

Let's Make a Deal

¶2. On August 31, Commerzbank finalized a deal to purchase Dresdner Bank from the insurance company Allianz SE for 9.8 billion euros ($14.4 billion). The bank will use shares and cash to buy 60.2% of Dresdner right away and acquire the rest by the end of 2009, pending shareholder approval. Allianz will acquire a 30% stake in the merged entity. Commerzbank also agreed to cover the first 275 million euros ($404 million) of potential losses on Dresdner's asset-backed securities, while Allianz will cover the next 975 million euros ($1.4 billion).

¶3. The deal ends months of speculation as potential bidders such Banco Santander and Lloyds TSB dropped out and China Development Bank lost the bidding. With 1.1 trillion euros ($1.6 trillion) in assets, the new entity merges Germany's second and third largest banks, but still lies well behind Deutsche Bank with its assets of 2.0 trillion euros ($2.94 trillion). Commerzbank will, however, become one of Germany's biggest retail bank with 1,200 branches, while the name Dresdner will eventually disappear from the market 130 years after the institution's founding.

What's in a Deal?

¶4. For Allianz, the deal ends seven unhappy years of ownership, as it already cut more than 18,000 jobs at Dresdner, or 40% of the workforce, and shed 32.6 billion euros ($48 billion) in assets. Having bought Dresdner for 23.5 billion euros in 2001 ($22 billion at the time), Allianz aimed to profit from cross-selling insurance and banking products. Not only did the strategy never take off, but Dresdner's investment bank branch, Dresdner Kleinwort, performed poorly compared to rivals, investing heavily in asset-backed securities which resulted in over 3 billion euros in write-downs and four consecutive negative quarters for the bank starting in August ¶2007.

¶5. Going forward, Commerzbank faces challenges in merging the two entities. A senior Deutsche Bank economist told Econ Off that he did not see a merger as a natural fit, saying that Dresdner Bank's focus on high-end clients and global investment banking did not mesh well with Commerzbank's regional portfolio and focus on Germany's small and medium-sized businesses. Commerzbank announced 9,000

potential lay-offs, both in Germany and abroad, to eliminate redundancies in the two Frankfurt-based entities, and will possibly wind down the unprofitable Kleinwort significantly. By tying up funds, the deal also stretches Commerzbank's overall capitalization during a time when banks have struggled to raise fresh capital. Despite the challenges ahead, an analyst at the German Council of Economic experts told Econ Off that the deal undoubtedly created "a second national champion" that would strengthen competition in the industry.

A Big Deal?

¶6. The Deutsche Bank economist dismissed the significance of the acquisition joking that it was "no big deal" as Commerzbank would only account for 6-8% of the assets held by German banks and is still small enough to be at risk of a takeover by a foreign bank. Germany's three-pillar banking system, wherein private banks only make up around 28% of the overall market, remains firmly in place, with the savings bank and cooperative bank pillars legally apart from the private banks. Nevertheless, the takeover caps a wave of deals within the private bank pillar in 2008 following Citigroup's sale of its German business to Credit Mutuel and KfW's sale of its stake in IKB to Lonestar, a U.S. private equity group.

¶7. The deal may also add impetus to Deutsche Bank's pursuit of Postbank. With its 14 million private accounts, Postbank would offer reliable income from retail banking to counterbalance Deutsche Bank's focus on global investment banking as well as a steady supply of funding when capital markets are not performing. No deal has been finalized and the state postal service may not agree to sell Postbank if it means large lay-offs.

¶8. A curious footnote on the takeover is the failed bid of state-owned China Development Bank (CDB). While it remains unclear whether CDB outbid Commerzbank and whether its offer was serious, such a takeover would likely have unleashed a firestorm of debate over the role of state-owned foreign companies in the German economy. The Deutsche Bank analyst said there was no "one view" in the political spectrum on the issue, but such a deal would have nonetheless provoked unease. The deal with Commerzbank keeps Dresdner "in the family" and creates a larger German entity capable of building a more global profile.

¶9. Comment: The merger of Germany's second and third largest banks was no doubt fuelled by the global financial turmoil which exposed the weaknesses of already troubled banks. Commerzbank will clearly be tied up absorbing Dresdner for the near future, while rivals such as Deutsche Bank eye other potential assets. Consolidation will continue within the three pillars of the system, but few foresee drastic changes to Germany's banking landscape on the horizon. End Comment.

¶10. This cable was coordinated with Embassy Berlin.
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